

DEFENSE CONTRACT AUDIT AGENCY

**AUDIT PROGRAM FOR COST ACCOUNTING STANDARD NO. 418
ALLOCATION OF DIRECT AND INDIRECT COSTS**

Contractor's Name: _____

Assignment Number: _____

Field Audit Office: _____

Date Assigned: _____

Auditor Assigned: _____

Supervisor's Signature Indicating
Approval (Obtain Signature Before
Starting Audit)

Note: Those steps not required should be marked "not applicable" (N/A). Portions of the audit which are covered in other assignments (e.g. incurred cost, Disclosure Statement, and internal control audits) should be referenced at the appropriate place in this program.

A. PURPOSE AND SCOPE

1. The purpose of CAS compliance auditing is to determine if the contractor's policies, procedures, and practices used to estimate, accumulate, and report costs on government contracts and subcontracts comply with the requirements of CAS. CAS 418 requires the consistent classification of costs as direct or indirect, establishes criteria for accumulating indirect costs in indirect cost pools, and provides guidance on allocating indirect cost pools. FAR 52.230-2, Cost Accounting Standards, requires the contractor to comply with the CAS 418 criteria.
2. The scope of this audit should generally be limited to CCFY. Some limited testing of prior year's transactions is acceptable to assure that no system changes were made. For efficiency, CAS compliance testing, if possible, should be performed concurrently with tests for compliance with FAR and contract terms.
3. This program is intended to provide for the proper planning, performance, and reporting on the contractor's compliance with CAS 418. The audit steps in the program should reflect a documented understanding between the auditor and the supervisor as to the scope required to comply in an efficient and effective manner with generally accepted auditing standards and DCAA objectives. The program steps are intended as general guidance and should be tailored as determined by audit risk.

B. AUDIT PLANNING CONSIDERATIONS

1. Before beginning any CAS compliance audit, the auditor should first determine if the contractor is subject to the CAS coverage. If the standard is not applicable to the contractor or noncompliance with the standard overall has no significant impact on government contract costs, there is no need to test whether the contractor is complying with the standard. The decision to not test for CAS compliance should be documented (see CAM 8-305 and DoD CAS Working Group Guidance Paper 76-7).
2. Materiality (see 48 CFR 9903.305) and audit risk assessment (including Internal Control Audit Planning Summary (ICAPS) for major contractors, SHORTICQ for nonmajors, and historical CAS problems) are also integral parts of the planning process and should be considered in developing the extent and frequency of CAS compliance tests.
3. Once it is determined that CAS 418 is applicable and material to the government, the auditor should assess:
 - a. which provisions of the standard are significant to the contractor. The decision to not test specific provisions of the standard for compliance should be documented.
 - b. the extent reliance may be placed on the contractor's system of internal controls to ensure compliance; and
 - c. the results of relevant other audits (e.g., results of prior compliance audits, Disclosure Statement revisions, etc.)

C. PRELIMINARY AUDIT AND RISK ASSESSMENT STEPS

	<u>Staff Hours</u>		<u>W/P Ref.</u>	<u>Auditor's Initials and Date Completed</u>
	<u>Budget</u>	<u>Actual</u>		
1. <u>Research and Planning</u>				
a. Read and become familiar with the criteria in CAS 418, CAM 8-418, and any recent Headquarters guidance not incorporated in CAM.				
b. Evaluate Parts III and IV of the contractor's Disclosure Statement to become familiar with the disclosed accounting practices. Document any ambiguities, vague descriptions, etc. Determine if the contractor's accounting system has remained unchanged since the last CAS compliance audit.				

		Auditor's Initials and Date	
		<u>Staff Hours</u>	<u>W/P</u>
		<u>Budget</u> <u>Actual</u>	<u>Ref</u> <u>Completed</u>
c. If changes have occurred, adjust audit scope accordingly.			
d. Evaluate recent forward pricing or incurred cost proposals to:			
(1) Determine whether total costs subject to CAS 418 are material. Consider contractor's sales mix (i.e., CAS-covered government contracts vs. not-CAS-covered and commercial) when determining materiality of costs subject to this standard. If not, discuss with the supervisory auditor or the technical specialist whether the audit should be continued.			
(2) Determine if the contractor has pre-established rates as described in 9904.418-50(g). If so, discuss impact of reduced risk with the technical specialist/supervisory auditor.			
e. Examine other FAO permanent file data (e.g. relevant audit leads, MAARs Control Log, etc.) and prior relevant audit work packages to determine what data are available, what audit steps were done in the past, and the results from those steps. This will identify areas of high risk and/or areas where limited or no compliance testing is necessary. Document results.			
f. Determine if contractor has written policies and procedures that classify costs as direct or indirect. If not, adjust audit scope accordingly.			
g. Discuss the planned compliance audit with the administrative contracting officer and, if appropriate, other customers to identify, understand, and document any concerns they may have or areas, which should be evaluated.			
2. <u>Entrance Conference</u>			
a. Arrange and conduct an entrance conference covering the areas highlighted in CAM 4-302 with particular emphasis on:			

		Auditor's Initials and Date	
		<u>W/P</u>	<u>Ref</u>
		<u>Budget</u>	<u>Actual</u>
		<u>Completed</u>	
<p>(1) Confirm that Policies and Procedures are current.</p> <p>(2) Requesting the contractor's explanation of the internal control structure as related to CAS 418.</p> <p>(3) Any changes since the last audit.</p> <p>(4) The contractor's monitoring process for classifying costs.</p> <p>(5) Any identified weaknesses which may have been reported and related follow-up actions.</p> <p>b. If reliance is to be placed on the work of others, the file should contain the required documentation (see CAM 4-1000).</p>			
3.	<u>Risk Assessment Steps</u>		
<p>a. Examine the SHORTICQ or relevant ICAPS (whichever is applicable), to obtain information regarding accounting system adequacy, identify any known relevant outstanding system deficiencies, and perform preliminary assessment of risk. Document results.</p> <p>b. If the contractor is classified as non-major (where ICAPS have not been completed) and if the evidential matter to be obtained during the audit is highly dependent on computerized information systems, document the audit work performed that supports reliance on the computer-based evidential matter. If the contractor's controls related to these systems have not been specifically/adequately tested in other audits, the auditor needs to either (1) develop, document, and reference in B-2 the procedures/tests in this audit that will support reliance on the evidential matter or (2) qualify the audit in accordance with CAM 10-210.4a and 10-804.4a.</p> <p>c. Document assessment of the contractor's internal control structure relative to this standard (control environment, accounting system, and relevant policies, procedures, and practices) to assure compliance with laws and regulations.</p> <p>d. Determine high-risk areas by performing the following limited testing. Using the most recent</p>			

incurred cost or forward pricing proposal, or current operating results (financial statements):

- (1) Determine which indirect pools/rates are significant and which, if any, are immaterial. (For immaterial pools/rates, discuss with the technical specialist and/or the supervisory auditor prior to performing additional effort.)
 - (2) For each significant indirect pool/rate, determine that actual cost elements included in each pool and allocation base are consistent with Disclosure Statement.
 - (3) Determine whether recent incurred cost or forward pricing audits included reclassification of costs between pools, or between direct and indirect costs.
 - (4) Compare the pools/bases to the disclosure statement to determine if any changes have been made to any accounting practices.
 - (5) Determine provisions of the standard that are material.
- e. In planning and performing the examination, review the fraud risk indicators in CAM Figure 4-7-3 for applicability to this audit. Document in working paper B any identified fraud risk indicators and your response/actions to those identified risks (either individually, or in combination). This should be done at the planning stage of the audit as well as during the audit if risk indicators are disclosed. If no risk indicators are identified, document this in working paper B.
- f. From the information gathered in the preceding steps and using the materiality criteria in 48 CFR 9903.305, assess the audit risk and determine the scope of audit and extent of compliance testing to be performed.

D. DETAILED AUDIT REQUIREMENTS

1. Determination of Direct Cost and Indirect Cost

- | | <u>Staff Hours</u> | <u>Budget</u> | <u>Actual</u> | Auditor's
Initials
and Date |
|---|--------------------|---------------|---------------|-----------------------------------|
| | | | | <u>Ref</u> <u>Completed</u> |
| a. Evaluate the contractor's written statements of accounting policies and procedures and determine that they adequately classify costs as direct or indirect (CAS 418.40(a)). | | | | |
| (1) The information disclosed by the contractor in its Disclosure Statement may be sufficient to make this determination. It should be considered before requesting additional information. | | | | |
| (2) Determine whether the written statements comply with the requirements of the standard as detailed in subsequent steps. | | | | |
| b. Evaluate the accounting for direct costs to determine that actual costs are used, except that: | | | | |
| (1) Standard costs may be used for direct labor and material as provided in CAS 407, or | | | | |
| (2) An average or preestablished direct labor rate may be used (CAS 418.50(a)(2)(ii)). | | | | |
| c. If average or preestablished direct labor rates are used, examine pay ranges within individual rate categories to determine whether the pay ranges are widely dispersed. If not widely dispersed, discuss with the technical specialist/supervisory auditor before continuing the audit effort on labor rates. | | | | |
| d. If pay ranges are widely dispersed, determine if the functions performed are not materially disparate and the employees are interchangeable with respect to the function by: | | | | |
| (1) Evaluating job descriptions | | | | |
| (2) Employee Interviews, and/or | | | | |
| (3) Requesting technical assistance, if necessary | | | | |
| e. If the functions performed are disparate, determine if the employees either work in a single production unit yielding homogeneous outputs or perform their functions as an integral team. | | | | |
| f. Evaluate the contractor's written policies and procedures and/or variance reports to determine if the variance between the average or preestablished | | | | |

direct labor rate and the actual rate for a cost accounting period, if material, is disposed of at least annually by allocation to cost objectives in proportion to the costs previously allocated to these cost objectives.

- g. Determine that any labor and material costs are accounted for as direct labor and material when such costs are specifically identified to any of the following cost objectives (CAS 418.50(a)(3)):
 - (1) Final cost objectives;
 - (2) Goods produced for stock or product inventory;
 - (3) Independent research and development and bid and proposal projects;
 - (4) Cost centers for accumulating costs identified with a process cost system (i.e., process cost centers);
 - (5) Goods or services produced or acquired for other segments of the contractor and for other cost objectives of a business unit; and
 - (6) Self-construction, fabrication, betterment, improvement, or installation of tangible capital assets.
- h. Test for contractor's practices for classification of direct vs. indirect costs. Discuss with the technical specialist/supervisory auditor a sampling plan to test/verify proper classification of direct/indirect costs. (MAAR 16)

2. Indirect Cost Pools (MAAR 16)

- a. From the contractor's most recent incurred cost submission, forward pricing rate proposal, or other supporting documentation, obtain a detailed breakdown of the contractor's significant indirect expense pools including service center pools.
- b. Analyze significant activities (considering disclosed descriptions of major functions and activities, descriptions of functional departments/codes, etc.) included in each pool identified in step 2.a. above and determine that the indirect cost pools are homogeneous based on the following criteria. (CAS 418.50(b)):

(1) All significant activities of the cost pool have the same or similar beneficial or causal relationship to cost objectives, or

(2) The separate allocation of costs of dissimilar activities would not result in a materially different allocation. The determination of materiality shall be made using the criteria provided in 48 CFR 9903.305.

(3) Apparent non-homogeneous expense elements/activities should be evaluated in detail to determine if they meet one of the two homogeneity criteria described in (1) and (2) above.

c. Determine that the homogeneous cost pool includes all the indirect costs identified with the activity to which the pool relates.
(CAS 418.50(b)(3)).

d. If the contractor's practice is currently in compliance because of the immaterial impact, document the file that periodic follow-up evaluations should be performed to ascertain whether circumstances have changed the cost impact from immaterial to material. This situation should be reported to the ACO when it is expected to have a material impact in the future and the probability of this impact can be specifically commented upon.

3. Allocation Bases for Indirect Cost Pools

(MAAR 18)

a. Analyze the indirect cost pools to determine whether:

(1) They include material amounts of costs for the management or supervision of activities involving direct labor or direct material costs. These will normally be those pools which relate to indirect costs, such as fabrication, production, manufacturing, engineering, etc. for a product or program, e.g., manufacturing, engineering, material overhead pools
(CAS 418.50(d)), or

(2) They do not include material amounts of costs for the management or supervision of activities involving direct labor or material costs. These will normally be those pools, which relate to indirect costs, such as service centers and other intermediate indirect pools (CAS 418.50(e)).

b. For the indirect pools identified in Step C.3a(1) above, determine that the contractor has selected one of the following allocation bases which represent the activity managed or supervised:

(1) Direct labor hour or dollar base - whichever is likely to vary in proportion to the costs included in the pool (CAS 418.50(d)(2)(i));

(2) The machine hour base is appropriate when the pool costs are predominantly facility related costs, such as depreciation, maintenance and utilities (CAS 418.50(d)(2)(ii));

(3) The unit of production base is appropriate when there is a production of comparable units (CAS 418.50(d)(2)(iii));

(4) The material cost base is appropriate when the activity being managed or supervised is a material related activity (CAS 418.50(d)(2)(iv)).

(5) Analyze detail breakdown of costs included in the allocation base and determine that the appropriate base selected under steps C.3b(1)-(4) above includes all significant elements of the selected base (e.g., overtime hours included in the direct labor hours base.)

(6) Analyze detail breakdown of cost objectives included in the allocation base and determine indirect cost pools are allocated to: (CAS 418.50(d)(3)):

- Final cost objectives
- Goods produced for stock or product inventory

- IR&D/B&P projects
 - Process cost centers
 - Goods or services produced or acquired for other segments of the contractor and for other cost objectives of the business unit.
 - Self construction, fabrication, betterment, improvement, or installation of tangible capital assets.
- c. For those indirect pools identified in step C.3a(2) above, determine that the contractor has selected a base which allocates the pooled costs using an appropriate measure of resource consumption. This determination will be made in accordance with the following hierarchy of acceptable methods (CAS 418.50(e)):
- (1) The resource consumption of the activities of the indirect pool. Examples include: machine usage hours (computer or reproduction equipment), or flight hours (company aircraft) (CAS 418.50(e)(1)).
 - (2) The output of the activity of the indirect pool, if resource consumption measures are unavailable or impractical to ascertain. Output is usually measured in terms of the units of end product of the activity such as number of printed pages (reproduction), number of reports (computer center), etc. (CAS 418.50(e)(2)(i)).
- When the level of resource consumption varies among the units of output, and a material difference would result, the output measure should be modified or more than one output measure should be used to reflect the resources consumed to perform the activity (CAS 418.50(e)(2)(ii)).
- (3) A surrogate which measures the activity of the cost objectives receiving the service is used only when neither the resources consumed nor the output of the activities can be measured practically. An example is the number of requisitions received from each requesting

activity for reproduction or computer service effort (CAS 418.50(e)(3)).

- (4) When the allocation(s) of indirect pools benefit one another, determine that the following acceptable allocation methods are used: (1) cross allocation, (2) sequential or (3) another method which produces results comparable to methods (1) and (2) (CAS 418.50(e)(4)).
 - (5) When services are provided simultaneously to two or more cost objectives, determine that the costs of the services are prorated among the cost objectives in reasonable proportion to the beneficial or causal relationship between the service performed and the cost objectives (CAS 418.50(e)(5)).
- d. Prior to recommending any changes to the contractor's existing allocation methods the auditor must first compute and analyze the allocations to final cost objectives which result from the use of the appropriate base in accordance with steps D.3b. and c. above. A comparison of such allocations will be made with those allocations using the existing base. Only when the comparison results in a material difference in the allocations to final cost objectives will a recommendation be made to change the allocation base.
- e. Determine whether the contractor has made any special allocation of indirect costs. If yes, determine:
- (1) If a particular cost objective receives significantly more or less benefit than would be reflected by the use of an acceptable base under CAS 418.
 - (2) Whether the government has agreed to the special allocation. If not, notify the ACO.
 - (3) When a special allocation is made pursuant to an agreement, determine if the amount of the special allocation is removed from the indirect cost pool and the particular cost objective's

base data from the base used to allocate the indirect cost pool.

- f. If preestablished rates are used in the allocation of an indirect cost pool, evaluate the contractor's policy, detailed calculation of the rates, and/or variance report to determine:

- (1) The preestablished rates reflect all costs and activities anticipated for a cost accounting period (CAS 418.50(g)(2)).
- (2) The rates are evaluated at least annually and revised as necessary to reflect the anticipated conditions. Such revisions may be made at the beginning or during the cost accounting period. In either case, the revisions should reflect the cost and activities for the entire cost accounting period (CAS 418.50(g)(2)).

When revisions are made during a cost accounting period, the prior allocation of costs is adjusted to reflect the revised costs if the accumulated variance between the original and revised rate is significant (CAS 418.50(g)(5)).

- (3) The variances are disposed at least annually (see 418.50(g)(2) and (g)(5) by allocating it to cost objectives in proportion to the costs previously allocated to the cost objectives by use of the preestablished rates. (CAS 418.50(g)(4)).
- (4) The contracting parties may agree to use preestablished rates in allocating indirect cost pools which are not based on cost accounting periods. When applicable, determine that the contractor has written policies for the establishment of the rates and the policies are consistently applied. Audit step C.3f(3) above also applies to these type of preestablished rates (CAS 418.50(g)(3)).

E. CONCLUDING AUDIT STEPS

1. Summarize the results of audit.

- | | <u>Staff Hours</u> | <u>W/P</u> | <u>Auditor's</u> |
|--|--------------------|---------------|-----------------------------|
| | <u>Budget</u> | <u>Actual</u> | <u>Initials</u> |
| | | | <u>and Date</u> |
| | | | <u>Ref</u> <u>Completed</u> |
2. Discuss results with *technical specialist/supervisor*. The auditor should only report those noncompliances which are considered material (see CAM 8-302.7).

 3. Coordinate significant or unusual issues with the ACO, FAO Manager, and if applicable, with the CAC, CHOA, or GAC network (see CAM 8-302.4 8-302.6). Coordination should be both before and after discussion of results with the contractor. The ACO should be apprised of noncompliance matters at the earliest possible date. If a noncompliance is considered immaterial, recommend to the ACO that the contractor be notified to reserve the Government's right should the cost impact become material (see FAR 30.602).

 4. Prepare draft audit report in accordance with CAM 10-805 (activity code 194XX) when no instances of noncompliances are found, or CAM 10-806 (activity code 19200) when instances of noncompliances are found.

 5. Conduct an exit conference with the contractor in accordance with CAM 4-304.

 6. Finalize audit report incorporating the contractor's response and audit rejoinder, if applicable.

 7. Closing actions should be performed in accordance with FAO procedures. These procedures may require either auditors or administrative personnel to perform various closing steps. Completion of these closing actions should be documented in the working papers and should include:
 - a. If the audit report has been electronically transmitted to the customer, file the signed original report in the audit working paper package. Otherwise, file a copy of the signed report.

 - b. Include a printed copy of the final draft audit report containing the supervisory auditor's initials and date on the top page, cross-

referenced to the working papers, in the working paper package. The final draft report should include all substantive changes made to the original draft, with cross-referencing updated as necessary. It should differ from the final report only due to minor administrative changes (spelling, format, etc.) made during final processing.

- c. Include an electronic version of the acknowledgement letter in the audit working paper package.
 - d. Include hardcopy printouts of the Administrative and Audit Working Papers indexes, including the supplemental listing of electronic files, in the working paper package.
 - e. Ensure all working paper files are "read only" and, if necessary, compressed for final storage. Generally, current Agency software should be used to automatically modify all electronic files for storage.
 - f. Two complete sets of electronic working papers must be prepared. The "original" set should be stored in the working paper package. The "archive" set is to be stored separately from the working paper package on removable media such as CD-ROM or diskette. If there will be a short-term need to access the working papers, a third, or "working" set should be stored so as to be available for reference, generally on the LAN. This set should be deleted when no longer needed.
 - g. Verify that electronic files stored on removable media are not corrupted and can be unarchived.
 - h. Securely enclose the "original" set of electronic files in the working paper package.
8. Update the permanent files, i.e., ICAPS or SHORTICQ, and Mandatory Annual Audit

	<u>Staff Hours</u>		Auditor's	
	<u>Budget</u>	<u>Actual</u>	W/P <u>Ref</u>	Initials and Date <u>Completed</u>
Requirements schedules. <i>Ensure that a copy of DMIS Report No. CAS 3 entitled "CAS Compliance Testing (Activity Code 194XX)" is included in the permanent file after the assignment has been closed in DMIS.</i>				

TOTAL HOURS